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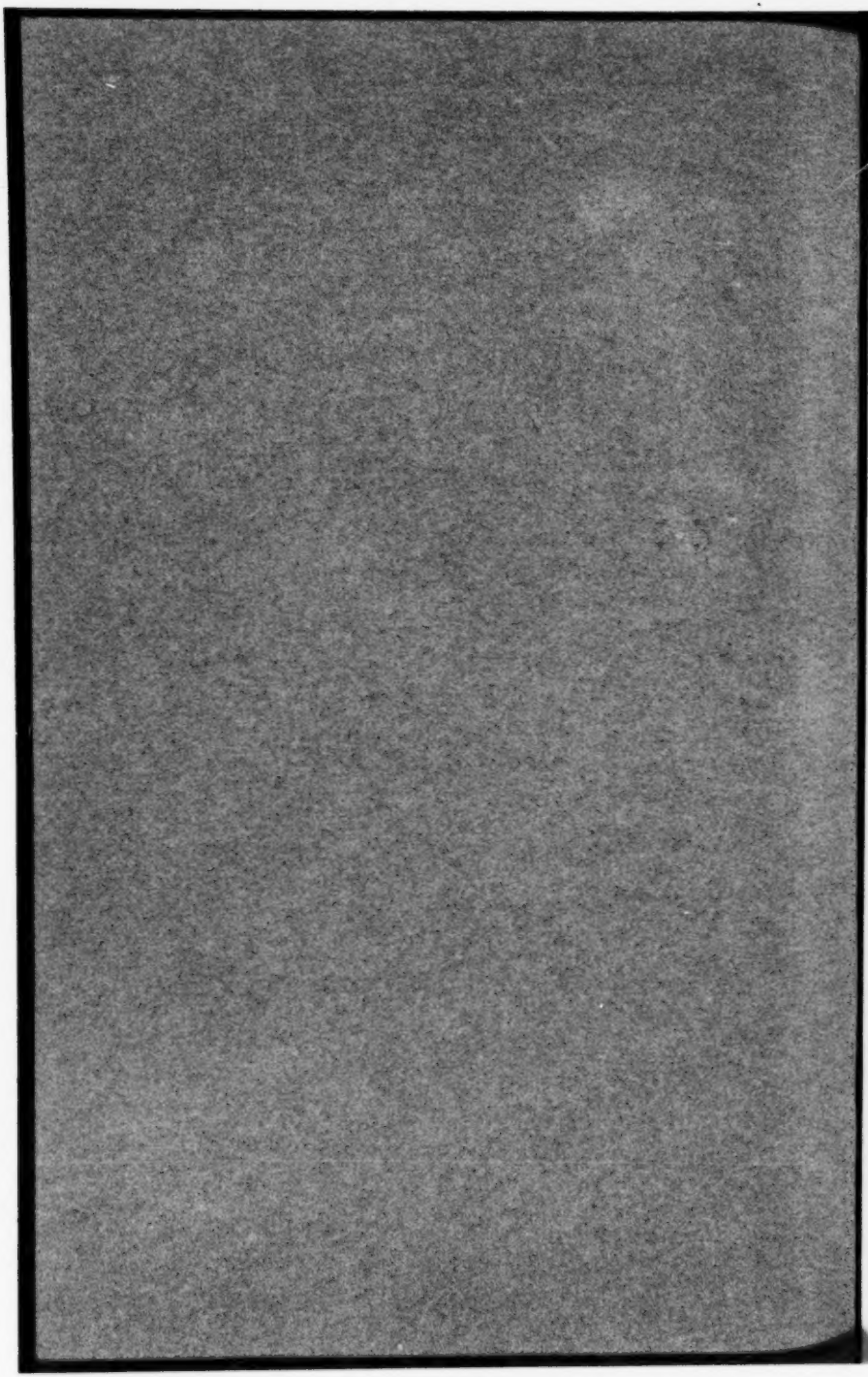

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

LOUIS LOBER,
Petitioner (Appellant below),
v.
CANADIAN PACIFIC RAILWAY COMPANY,
Respondent, et al. (Appellees below)
No.....

BRIEF AND ANSWER OF CANADIAN PACIFIC RAILWAY COMPANY IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

STATEMENT OF THE CASE

The Duluth, South Shore and Atlantic Railway Company, hereafter called South Shore, which connects with the Canadian Pacific Railway across the International Bridge between Sault Ste. Marie, Michigan, and Sault Ste. Marie, Ontario, was organized in 1886-1887 by a Syndicate, which did not include any officer or employee of Canadian Pacific Railway Company, hereafter called Canadian Pacific (R. 12, 18, 41).

The Syndicate acquired the property of the bankrupt Detroit, Mackinac and Marquette Railway Company; contracted for the construction of certain additional trackage; acquired practically all of the stock of Marquette, Houghton & Ontonagon Railroad Company; hereafter called Marquette; and caused Marquette to execute a perpetual lease of its properties to South Shore, at a minimum annual rental sufficient for the payment of 6%

dividends on the Marquette preferred stock and the payment of interest ranging from 8% to 6% on four issues of Marquette bonds outstanding in the aggregate amount of $4,903,700 (R. 18).

The Syndicate then caused South Shore to execute its first mortgage dated April 15, 1887; and to subject to the lien thereof its "right to possess, maintain and operate" the Marquette properties under said lease; and to issue $4,000,000 of 5% bonds maturing on January 1, 1937, hereafter called Fives, secured by said mortgage (R. 12).

By the year 1888, South Shore had incurred a short term floating debt of about $1,200,000. In that year, Canadian Pacific acquired a majority of South Shore's capital stock, and ever since that time has caused it to be voted in favor of the persons who were elected to South Shore's Board of Directors (R. 19).

By July 17, 1890, South Shore's floating debt had increased to $3,733,749, of which $1,764,393 consisted of advances made by Canadian Pacific. $878,886 of this floating debt consisted of short term borrowings which South Shore used to pay the rentals due under the Marquette lease (R. 19).

On July 17, 1890, the interested parties undertook to reorganize South Shore on the following basis:

(1) South Shore executed its First Consolidated 4% 100-year Gold Mortgage dated July 17, 1890, which provided for the issue of 4% bonds maturing in 1990, hereafter called Fours, for the purpose, *inter alia,* of retiring the Fives and the various issues of Marquette bonds then outstanding, bearing interest at the rates of 8% and 6% per annum (R. 20, 21).

(2) The lease of Marquette's properties to South Shore was abrogated, and Marquette's properties were

conveyed in fee to South Shore, in consideration of South Shore's assumption of the payment of all outstanding Marquette bonds; its undertaking to pay specified amounts to the Marquette stockholders, either in Fours or in cash; and the waiver of its claim to be reimbursed for certain improvements on Marquette properties (R. 20).

(3) South Shore and Canadian Pacific executed a Traffic Agreement dated May 27, 1890 (to which the holders of Fives were not parties), in which, among other things, South Shore agreed to apply corresponding amounts of Fours "to the sole purpose of retiring, at or before maturity" the outstanding South Shore Fives and Marquette bonds, and Canadian Pacific agreed, on certain conditions, to guarantee the payment of interest on the Fours so issued "as fast as" they were exchanged for any of said outstanding bonds (R. 51, 52).

The Trial Court found as a fact that:

> "The purpose of the parties entering into said instruments was to benefit themselves by readjusting and stabilizing South Shore's finances on a sound basis through a consolidation of the funded and floating debt of the South Shore and of Marquette, Houghton & Ontonagon Railroad Company in Fours maturing at a much later date and bearing a lower rate of interest than the previously outstanding bonds of said two companies" (R. 60, 61).

In 1936, South Shore was insolvent, and the necessity of an early reorganization of its financial structure was apparent (R. 22-24). South Shore and Canadian Pacific, under date of May 22, 1936, executed a Supplement to the Traffic Agreement dated May 27, 1890. In this Supplement they referred to the provisions of the Traffic Agreement respecting the issue by South Shore of Fours in

exchange for outstanding bonds and the guarantee by Canadian Pacific of the payment of interest on Fours so exchanged, and to the fact that South Shore was then in need of reorganization and neither South Shore nor Canadian Pacific would derive any benefit from the issue of additional Fours in such exchanges. Thereupon, the parties agreed that South Shore would close the Fours mortgage; and that the provisions of the Traffic Agreement respecting the issue by South Shore, and guarantee by Canadian Pacific, of additional Fours, should be abrogated (R. 57, 58).

No demand was ever made "at or before" the maturity of the Fives on January 1, 1937, that any of the Fives now outstanding be exchanged for guaranteed Fours (R. 61, 95).

On January 2, 1937, South Shore initiated its pending proceeding for a reorganization under Section 77 of the Bankruptcy Act (R. 15).

In the Section 77 Proceeding, the Trustees of the Fours mortgage filed a claim for $15,107,000, principal amount, of Fours and unpaid interest coupons attached to said bonds in the amount of $23,090,635, all of which were owned by the Canadian Pacific, in addition to which the latter company had other claims against the debtor (R. 26).

In behalf of the holders of Fives other than the Canadian Pacific, there was formed a first mortgage bondholders' Protective Committeee, which raised objections to the allowance of the claims of the Canadian Pacific, and sought to have them subordinated to the claims of other holders of Fives, not only because of the abrogation of the exchange provisions of the Traffic Agreement on May 22, 1936, but also by reason of the entire alleged

relationship between Canadian Pacific and South Shore from 1888 down to the beginning of the latter's Section 77 Proceeding (R. 72).

Prior to a hearing on the above mentioned objections to the claims of the Canadian Pacific, the first mortgage bondholders' Protective Committee sponsored the prosecution, in the Court in which the Section 77 Proceeding was pending, of the suit known as *McCullough vs. Canadian Pacific Railway Company,* 53 Fed. Sup. 534.

In this action, McCullough, an owner of South Shore Fives, asserted that the holders of Fives became entitled under the Traffic Agreement, of 1890, as third party beneficiaries, to have the provisions of that agreement respecting the exchange of Fives for Fours guaranteed as to interest by Canadian Pacific kept open until the maturity of the Fives on January 1, 1937; and that the abrogation thereof in the Traffic Agreement Supplement constituted a fraud upon South Shore's creditors. McCullough sought a decree against Canadian Pacific for specific performance of the abrogated provisions of the Traffic Agreement or, in the alternative, a judgment for damages.

In the McCullough case, the District Court held that holders of Fives were not creditor beneficiaries under the Traffic Agreement; that they were donee-beneficiaries; that their rights as such had expired before they sought to exercise them; and that McCullough could not recover on any of the theories he had advanced.

The present petitioner and the holders of Fives represented by him declined to have anything to do with the McCullough suit, and were not bound by the judgment therein which was entered on June 20, 1943.

Not until April 17, 1944, did petitioner intervene in the Section 77 Proceeding in behalf of himself and other

holders of Fives, aggregating all told $157,000 in principal amount (R. 1, 7).

On August 21, 1944, petitioner filed in the Section 77 Proceeding his petition that all claims of Canadian Pacific against South Shore be subordinated to the claims of holders of Fives, on the theory that they had a right as third party beneficiaries under the Traffic Agreement to exchange their Fives for guaranteed Fours of which they were deprived by Canadian Pacific through the amendment of the Traffic Agreement (R. 11-17).

Petitioner based his case for such subordination, as the Court of Appeals found, "solely upon the legal effect of the Traffic Agreement, the insolvency of South Shore at the time of its abrogation, and Canadian's ownership of a majority of South Shore's capital stock, without proof or claim of mismanagement of South Shore by Canadian, or any showing otherwise of inequity in any of Canadian's claims" (R. 93).

The Bankruptcy Court made Findings of Fact and Conclusions of Law and entered an order that the petition be denied, assigning reasons (R. 59-73). Petitioner then appealed to the Circuit Court of Appeals, which, after hearing argument thereon for the better part of a day, filed an opinion stating its reasons for affirming the judgment of the Bankruptcy Court, and ordered judgment to that effect (R. 85-97).

Petitioner is here seeking a Writ of Certiorari to review the decision of the Court of Appeals.

ARGUMENT

The Court of Appeals' Decision Must Stand Unless This Court Will Reverse That Court's Interpretation of a Contract.

Petitioner is seeking by means of Certiorari to obtain a review of the Court of Appeals' interpretation of the contract embodied in the Traffic Agreement (R. 47-54), which South Shore and Canadian Pacific entered into on May 27, 1890.

In order for petitioner to prevail in the Court below, he had to establish the following propositions:

(1) That holders of Fives were third party beneficiaries under the Traffic Agreement, having as such an indefeasible right (a) to enforce a promise allegedly made in that Agreement to Canadian Pacific by South Shore to issue Fours in exchange for Fives, "at or before maturity" of the Fives which matured on January 1, 1937, and (b) to enforce the promise made by Canadian Pacific to South Shore in the Traffic Agreement to guarantee, on certain conditions, the payment of interest on Fours issued in exchange for Fives.

(2) That holders of Fives demanded Fours in exchange for their Fives "at or before maturity" of the Fives, and thus became entitled under the Traffic Agreement to Fours and to the guarantee of interest thereon.

(3) That holders of Fives were prevented from obtaining Fours thus guaranteed, because of the abrogation of the exchange provisions of the Traffic Agreement in the Supplement of May 22, 1936 (R. 57, 58), on which petitioner based his contention that all claims of Canadian Pacific against South Shore should be subordinated to the claims of holders of Fives.

The Court of Appeals disposed of petitioner's case as follows:

Petitioner "misinterprets" the Traffic Agreement as requiring South Shore to *exchange* Fives for Fours. In the Traffic Agreement South Shore merely promised that it would "apply" Fours to the "purpose of *retiring* at or before maturity" the Fives. South Shore could fulfill that promise, without exchanging Fours for Fives, by selling Fours and purchasing Fives with the proceeds (R. 95).

On the Court of Appeals' foregoing interpretation of the Traffic Agreement, South Shore never made the alleged promise to issue Fours in exchange for Fives; and the alleged right of holders of Fives to enforce such a promise as third party beneficiaries never existed; hence no such right was defeated through the amendment of the Traffic Agreement.

That interpretation of the Traffic Agreement contract necessitates *per se* an affirmance of the decision below and makes it unnecessary to consider what follows, unless this Court is prepared to review an interpretation of a contract by a Court of Appeals.

The Court of Appeals further held that, if it were assumed that South Shore made the alleged promise to Canadian Pacific to issue Fours in exchange for Fives "at or before maturity" of the Fives and that holders of Fives were entitled to enforce such a promise as third party beneficiaries, they were beneficiaries of a mere *option* which they would have to exercise before it expired in order to entitle them to the Fours, but which they made no attempt to exercise "until after the right, as they define and limit it, had expired" (R. 95, 96).

Thus, even if holders of Fives had an indefeasible right to exchange them for guaranteed Fours "at or before

maturity" of the Fives, it was merely a right to an option which expired when the Fives matured on January 1, 1937. Hence, any loss they may have sustained in not obtaining such exchanges is attributable to their failure to exercise the option before it expired on the above date, not, as petitioner pretends, to any action on the part of Canadian Pacific concerning the amendment of the Traffic Agreement on May 22, 1936.

The foregoing alternative interpretation of the Traffic Agreement contract, as giving holders of Fives a mere *option* expiring on January 1, 1937, to obtain the exchanges would necessitate *per se* an affirmance of the decision below and make it unnecessary to consider what follows, unless this Court is prepared to review an interpretation of a contract by a Court of Appeals.

The Alleged Conflict of the Present Decision With Previous Decisions of This Court Is Non-existent.

There is no foundation for petitioner's assertion that the Court of Appeals' decision that holders of Fives were not entitled to the subordination of Canadian Pacific's claims conflicted with this Courts decision in *Prudence Realization Corp. vs. Geist,* 316 U. S. 89, wherein the Court declared that:

> "It is a familiar equity rule applied by federal courts in liquidation proceedings under federal statutes that a solvent guarantor or surety of an insolvent's obligation will not be permitted * * * to compete with other creditors, payment of whose claims he has undertaken to assure, until they are paid in full."

That rule is not in point, because Canadian Pacific is not in the position of a guarantor with respect to petitioner or any other holder of Fives; and because they

allowed their right, if any, to obtain guaranteed Fours to lapse and expire when the Fives matured on January 1, 1937.

Nor is there any foundation for petitioner's assertion (Pet. p. 13) that the Court of Appeals' decision conflicts with this Court's decisions in *Taylor vs. Standard Gas & Electric Co.*, 306 U. S. 307; and *Consolidated Rock Products Co. vs. DuBois*, 312 U. S. 510.

In those cases it was established as a fact by competent evidence that the majority stockholder actually exercised its power to dominate its subsidiary, mismanaged its affairs, and caused it to take action which violated the rights of the subsidiary's creditors. No such proof was adduced in the present proceeding.

As the Court of Appeals pointed out, petitioner considered it an "unnecessary waste of time" to inquire into the entire relationship from 1888 to the present between Canadian Pacific and South Shore, in an attempt to establish a violation of Canadian Pacific's fiduciary duty as a majority stockholder (R. 93).

As the Court of Appeals held, petitioner based his contention that the Canadian Pacific claims should be subordinated

> "solely upon the legal effect of the Traffic Agreement, the insolvency of South Shore at the time of its abrogation, and Canadian's ownership of a majority of South Shore capital stock * * *" (R. 93),

and submitted his case

> "without proof or claim of mismanagement of South Shore by Canadian, or any showing otherwise of inequity in any of Canadian's claims" (R. 93),

with the result that this action

> "does not involve an inquiry into the question of whether Canadian has faithfully met its obligation as a fiduciary imposed on it by its ownership of a

majority of the capital stock of South Shore throughout the years of its alleged management and control of South Shore" (R. 93).

The Court of Appeals also pointed out that

> "The questions which arise in such an inquiry are all before the Bankruptcy Court in the proceeding instituted by the bondholders' Protective Committee, and have been expressly reserved by the Bankruptcy Court for decision in that proceeding" (R. 93, 94),

and concluded that

> "There is, therefore, no room in the present action for application of the rules laid down in *Case vs. Los Angeles Lumber Co.*, 308 U. S. 106; *Consolidated Rock Products Co. vs. DuBois*, 312 U. S. 510; *Pepper vs. Litton*, 308 U. S. 295; *Prudence Realization Corp. vs. Geist*, 316 U. S. 89" (R. 94).

Petitioner insists that this case is essentially similar to the Standard Gas & Electric Co. and Consolidated Rock Products Co. cases, *supra*, in which actual domination of a subsidiary by its majority stockholder was established by competent evidence. He contends that it is a necessary inference in the present case that South Shore's joinder in the Supplement abrogating the exchange provisions of the Traffic Agreement was procured by Canadian Pacific domination.

That contention was rejected by the Trial Court which, after full consideration of the evidence, found as a fact that South Shore's joinder in the Supplement to the Traffic Agreement "was not caused by, or attributable to, any domination on the part of Canadian Pacific" (R. 62).

Assuming, however, that petitioner had produced evidence establishing his contention that the abrogation of the exchange provisions of the Traffic Agreement was procured by Canadian Pacific domination, there would still remain an essential distinction between the present

case and the above cited decisions, in that *here* there was no violation of any right of the subsidiary's creditors.

As previously shown, the Court of Appeals held that the Traffic Agreement imposed no obligation on South Shore to exchange Fives for Fours or, at most, gave holders of Fives an option to demand such exchanges at or before January 1, 1937, which they allowed to expire without being exercised. On either interpretation, no right of holders of Fives was violated by the Supplement to the Traffic Agreement, even assuming that it was procured by Canadian Pacific domination.

Thus, there is no conflict between the present decision and the Standard Gas & Electric Co. and Consolidated Rock Products Co. cases, *supra,* because they were based on two essential grounds *neither* of which was established in this case: first, that the majority stockholder actually exercised its power to dominate its subsidiary; second, that the power of domination was so exercised as to violate the rights of the subsidiary's creditors.

Nor is the present decision in conflict with this Court's decision in *Case vs. Los Angeles Lumber Co.,* 308 U. S. 106. In that case, this Court held that a Plan of Reorganization was not fair and equitable because it violated the rights of bondholders in and to the debtor's property

> "since the full value of that property is not first applied to claims of the bondholders before the stockholders are allowed to participate" (308 U. S. 120).

That decision is not in point because, first, petitioner has not established that holders of Fives had the right of exchange which he asserts was violated and, second, assuming that they had such a right, no violation thereof has been established, but only a failure to exercise it.

Hence, there is no foundation for the contention that Canadian Pacific violated its fiduciary duty as South

Shore's majority stockholder not to cause that Company to take any action whereby the rights of its creditors would be infringed.

The Alleged Conflict of the Present Decision With Decisions of Other Courts of Appeals Is Non-existent.

There is no foundation for petitioner's assertion that the Court of Appeals' decision conflicted with the following decisions of other Courts of Appeal:

Hanssen vs. Wingren, 121 F. (2d) 1011 (C. C. A., 10th, 1941); *In re American Fuel & Power Co.,* 122 F. (2d) 223 (C. C. A., 6th, 1941); *Stone vs. Eacho,* 127 F. (2d) 284 (C. C. A., 4th, 1942); *In re Commonwealth Light & Power Co.,* 141 F. (2d) 734 (C. C. A., 7th, 1944).

Petitioner makes no attempt to show wherein the present decision conflicted with any of the above cited cases. We have examined them and find no such conflict.

The relief granted in *Stone vs. Eacho* and in the *Commonwealth Light & Power Co.* case, *supra,* was based on three grounds, all of which were established in each of those cases: First, the majority stockholder completely dominated and controlled the action of its subsidiary which was complained of; second, the complaining creditors had the rights they claimed to have; third, such rights were violated through the action complained of. As previously shown, none of those grounds for relief was established in the present case.

The facts in *Hanssen vs. Wingren, supra,* and *In re American Fuel & Power Co., supra,* are so entirely different that there is not the slightest analogy between them and the present case.

The Suggested Conflict of the Present Decision With New York Law Is Non-existent.

Petitioner asserts that it is firmly settled under the law of New York (concededly controlling in this case) that the rights of donee-beneficiaries are indefeasible, as if the Court of Appeals had held in the present case that holders of Fives had rights as donee-beneficiaries and that such rights were defeasible (Br. 12).

Holders of Fives could not possibly be donee-beneficiaries of the exchange provisions of the Traffic Agreement, according to the latest decision of the New York Courts which we found and cited in the Court of Appeals, but which petitioner ignores. *First Trust Company of Albany vs. Arnold,* 39 N. Y. S. (2d) 175. In that case, decided on December 29, 1942, the Court cited previous New York decisions as authority for the following statement in the opinion:

> "an examination of the law reveals that a donee-beneficiary must be related by blood or marriage in order to avail himself of a contract made for his benefit or the contract must be a public benefit contract."

However, in the present case, the Court of Appeals did not find it necessary to determine whether holders of Fives were or were not donee-beneficiaries, or whether, if they were, their rights as such were defeasible or indefeasible. It merely assumed arguendo that they were donee-beneficiaries (R. 96). It held that their alleged right of exchange, whether as donee-beneficiaries or as third party beneficiaries *"of some undefined category,"* was a "mere option" which they made no attempt to exercise "until after the right, as they define and limit it, had expired" (R. 95, 96).

Since the right, if any, to obtain the exchanges was merely a right to an option which would *ipso facto* expire on January 1, 1937, unless exercised on or before that date; and since it did expire on that date without any attempt to exercise it, the question whether it was or was not indefeasible prior to such expiration, *i. e.,* whether it had been effectively terminated on May 22, 1936, by the Supplement to the Traffic Agreement was purely *academic,* and was not passed on by the Court of Appeals.

The Suggested Question As to Whether a Proposed Plan of Reorganization Is Fair and Equitable Is Not Involved in This Proceeding.

Petitioner goes outside the record in this proceeding to allege, as if of sinister significance, that the Protective Committee for the Fives and the Canadian Pacific have agreed on a Plan of Reorganization for South Shore. He says he ascertained the contemplated provisions from an inspection of the written agreement, which he asserts was brought to the attention of the Judge of the Bankruptcy Court in the presence of petitioner's counsel in October, 1944 (Pet. p. 9).

Petitioner suggests that this indicates an intention on the part of the Protective Committee not to litigate, but to compromise, the issue now pending in the Bankruptcy Court as to whether the Canadian Pacific disregarded its fiduciary duty as a majority stockholder, in connection with the management of South Shore's affairs. He implies that the Protective Committee is not adequately protecting the interests of holders of Fives.

Since South Shore is in a Section 77 Proceeding, no Plan of Reorganization can be consummated until it is filed with the Court and the Interstate Commerce Com-

mission; adopted or modified by the Commission; submitted to and approved by two-thirds of the holders of each class of securities not found to be valueless; and thereafter ratified after hearing by the Bankruptcy Court as being "fair and equitable."

In the course of the numerous hearings before the Court and Commission on any Plan which may be filed, the present petitioner and any other holder of Fives will have ample opportunity not only to vote against it, but to show the Court and the Commission, if he can, that it is not fair and equitable.

We respectfully submit that the petition for Certiorari should be denied.

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